United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

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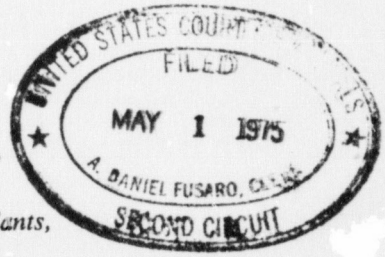
75-7030

United States Court of Appeals

For the Second Circuit

Docket No. 75-7030



FRIGITEMP CORP., GERALD LEE, GERALD ROSS, HENRY GUTMAN and LEON GUTTMAN,

Plaintiffs-Appellants,

against

FINANCIAL DYNAMICS FUND, INC., FINANCIAL INDUSTRIAL FUND, INC., FINANCIAL VENTURE FUND, INC., FINANCIAL PROGRAMS, INC., ROBERT E. ANTON and JOHN M. BUTLER,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF PLAINTIFFS-APPELLANTS

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On Appeal from the United States District Court for the Southern District of New York (Tenney, J.)

REPLY BRIEF OF PLAINTIFFS-APPELLANTS

Preliminary Statement

Defendants, in their answering brief, have not and cannot dispute plaintiffs' allegations

(1) that the defendants cornered the market in Frigitemp's stock and thereby artificially inflated the

price thereof*;

(2) that in connection therewith, the defendants obtained inside information from the plaintiffs in the Private Placement, which they used in continuing to purchase Frigitemp's stock in the over-the-counter market; and

(3) that the defendants failed to disclose to the plaintiffs in the Private Placement that they intended to use the inside information they were obtaining in furtherance of their scheme to corner the market in Frigitemp's stock.

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* Two of the defendants have recently consented to an order charging these wrongs in a proceeding brought by the Securities and Exchange Commission (S.E.C.). In the Matter of Financial Programs, Inc., [Current Transfer Binder] CCH Fed. Sec. L. Rep ¶ 80,146 (March 24, 1975). Specifically, the S.E.C. has charged, among other things, that from 1969 to May 1970 defendant Financial Programs, Inc. ("Financial Programs") and certain of its officers, including defendant Anton, purchased for the defendant mutual funds ("the Funds") most of the publicly traded stock of various over-the-counter companies, including Frigitemp; that "[b]ecause of those substantial purchases, the prices of the securities rose" "to unreasonably high levels" which were "unrealistic guides to fair value"; that "the ascending market prices had been caused and were being maintained by the Funds' own purchases"; and that when the Funds began selling in 1970, the prices of the securities were necessarily driven downward. In the matter of Financial Programs, Inc., supra at p. 85,239-240. Violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder are charged together with violations of the anti-fraud provisions of the Securities, Investment Company and Investment Advisors Acts. Upon an offer of settlement accepted by the S.E.C., a consent order has been entered by the Commission against Financial Programs and two of its former officers.

"The proper test is whether the plaintiff

Defendants do not deny or attempt to justify their wrongful market manipulation. Instead, they urge that neither the common law of New York nor § 10(b) of the 1934 Act provides a remedy to Frigitemp. Under the facts of this case, defendants' position is untenable.

Defendants are accused of having wrongfully used inside information in manipulating the price of Frigitemp's stock from $15.25 to a high of $37 per share between March 1969 and March 1970 (A7a; 151-170a) and of having driven the price back down to under $5 by the end of 1970. (A151-170a). As a result of the defendants' activities, Frigitemp has been sued in a class action by its shareholders seeking recovery for losses incurred by those who purchased at the artificially inflated prices and who either sold or held their shares at lower prices. The costs to Frigitemp of defending that action are damages for which Frigitemp can recover against the defendants herein. Moreover, Frigitemp should be permitted to recoup defendants' illegal profits to compensate it for the damage to the integrity of the market for its securities, to deprive defendants of these wrongful profits, and as a prophylactic device to discourage manipulative abuses such as those engaged in by the defendants. Surely a corporation should not be required to stand idly by while the market for its shares is being cornered by persons who

are trading upon inside information disclosed to them in confidence in a private financing and without knowledge of the wrongful use to which it was to be put.

The individual plaintiffs' claim also should be sustained. They contributed 100,000 shares to the capital of Frigitemp as a condition of the Private Placement without disclosure by the defendants that the inside information obtained by them in connection with the Private Placement had and would continue to be used to corner the market in Frigitemp's shares. Had that disclosure been made, the individual plaintiffs would have been duty bound to refuse to permit Frigitemp to enter into the Private Piacement and to terminate all dealings with and disclosures to the defendants.

ARGUMENT

POINT I

FRIGITEMP SHOULD BE PERMITTED TO MAINTAIN ITS CLAIMS AT COMMON LAW AND UNDER § 10(b).

A. Frigitemp May Sue Under the New York Common Law

Frigitemp alleges in its first cause of action that defendants cornered the market in its common stock using confidential inside information obtained from June to August 29, 1969 in connection with the Private Placement. As the Funds bought from March 1969 to March 1970 Frigitemp's stock increased in price from $15.25 to $37 per share (A7a; 151-170a) and fell to $5 per share as the Funds sold out in 1970 (A151-170a).

On May 9, 1973, Frigitemp was sued in the Southern District of New York in a class action allegedly brought on behalf of all those who purchased shares of Frigitemp since 1969 and who incurred losses. (Kaye v. Lee, et al. (S.D.N.Y. 73 Civ. 2052)). (A11a). Frigitemp herein alleges that any losses incurred by these purchasers were caused by defendants wrongful manipulation of the market price of Frigitemp's shares. Moreover, Frigitemp alleges that it "has incurred substantial expenses, including legal expenses, in defending Kaye v. Lee, et al. and may be liable to the plaintiffs therein, in an amount presently unknown, by reason of the

acts of defendants." (A11a).

Frigitemp's has an even greater right to relief than those sustained for the corporations in Diamond v. Oreamuno, 24 N.Y. 2d 494, 301 N.Y.S. 2d 78 (1969) or Schein v. Chasen, 478 F. 2d 817 (2d Cir. 1973), vacated sub nom Lehman Bros. v. Schein, 416 U.S. 386 (1974), or Davidge v. White, 377 F. Supp. 1084 (S.D.N.Y. 1974). Frigitemp does not sue only for defendants' wrongful profits from their fraudulent and manipulative acts which resulted in the impairment of the market for its securities. Frigitemp also has suffered specific damages as a result of defendants' acts and seeks recovery therefor.

Defendants have argued that Frigitemp may not recover at common law because the defendants were not its officers or directors but were "unrelated third parties" who dealt with the corporation "at arms length" and received such information as a purchaser of corporate securities. (Defendants' Brief, page 20). These are hardly accurate characterizations of the defendants' relationship to Frigitemp and the nature of the circumstances under which they received inside information.

The defendants are substantial financial institutions and their agents. They were furnished with inside information concerning Frigitemp's business and affairs in connection with a private financing. This information was

furnished solely for the purpose of their investment, and was furnished in confidence. Defendants seek to characterize the Private Placement as an ordinary securities purchase. To the contrary, the relationship between Frigitemp and the defendants for all practical purposes, was the same that exists between an investment banker who acquires confidential information in connection with an underwriting or placement of a corporation's securities. Both make substantial purchases of securities either for investment or resale to the public and both are given detailed confidential corporate information solely for that purpose.

In Shapiro v. Merrill Lynch Pierce Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972) aff'd 495 F. 2d 288 (2d Cir. 1974) a claim against an investment banker was sustained for trading profits realized from the misuse of confidential information obtained in a corporate financing. The district court specifically recognized the special relationship of and the duties imposed with respect to the use of confidential information obtained by a financial institution in connection with a financing.

Plaintiffs submit that the defendants had the same fiduciary responsibilities as would Frigitemp's own officers and directors in dealing with material corporate information imparted to them in confidence for the exclusive purpose of a major financing. Defendants were, for these purposes,

fiduciaries of Frigitemp.

Defendants argue that existing cases require the involvement of a corporation's directors and officers in the misuse of inside information for recovery by it. An examination of these cases reveals this is not so. In Brophy v. Cities Service Co., 31 Del. Ch. 241, a principal authority for the decision in Diamond v. Oreamuno, supra., a mere employee was held responsible. In Davidge v. White, supra., the defendant held liable to the corporation was not a director or officer when he misused inside information. Moreover, in Schein v. Chasen, supra., the director who furnished the inside information to those who misused it, in fact, did not act in concert with them nor profit by their wrongdoing.

Finally, defendants urge that the information disclosed to them "was disclosed by Frigitemp in order to induce FVF to make a substantial investment in Frigitemp" (Defendants' Brief page 17). This is quite correct. However, this was the only purpose for disclosure of this information. It was not disclosed to the defendants to permit them to trade and corner the market in Frigitemp's shares.

The nondisclosure by the defendants of their intention to misuse the inside information disclosed to them in confidence also is actionable under the common law of fraud and deceit. See, e.g., Amend v. Hurley, 293 N.Y. 587,

596 N.Y.S. 2d (1944); Wood v. Amory, 105 N.Y. 278, 281-82 (1887); People's Bank v. Bogart, 81 N.Y. 101, 107-08 (1880); Warren Bros. Co. v. New York State Thruway Authority, 34 App. Div. 2d 97, 99, 309 N.Y.S.2d 450, 452 (3d Dep't 1970), aff'd, 34 N.Y.2d 770, 358 N.Y.S.2d 139 (1974); Moser v. Spizzirro, 31 App. Div. 2d 537, 295 N.Y.S.2d 188, 188-89 (2d Dep't 1968), aff'd, 35 N.Y. 2d 941, 305 N.Y.S.2d 153 (1969); Dash v. Jennings, 272 App. Div. 1073, 1074, 74 N.Y.S.2d 881, 883 (2d Dep't 1947).

B. Frigitemp Has Standing To Sue Under § 10(b) of the 1934 Act

Frigitemp alleges that the defendants' trading on the confidential information furnished to them in order to corner the market in Frigitemp's shares was a violation of § 10(b) and Rule 10b-5 and the defendants' failure to disclose their plans to Frigitemp was a material omission under Rule 10b-5.

Defendants contend that even if they violated § 10(b) and Rule 10b-5 by using material inside information to corner the market in Frigitemp's common stock, Frigitemp was neither a buyer nor seller of its own stock in the open market and therefore has no standing to sue (Defendants' brief, page 23). Defendants' position is incorrect and, moreover, ignores the full extent of Frigitemp's claim: (a) that the Funds engaged in a manipulative scheme to corner the market in Frigitemp's shares; and (b) as a part of that scheme the defendants fraudulently obtained inside information in connection with the Private Placement without disclosing tneir intention to use that information to carry forward the market manipulation.

The Private Placement was an integral part of the defendants' fraudulent scheme. It was for the sole purpose of that transaction that the defendants were furnished inside information which they misused in buying up all but a small part of Frigitemp's stock. Accordingly, Frigitemp has

standing under § 10(b) and Rule 10b-5. Superintendant of Insurance of Bankers Life & Casualty Co. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972) aff'd 495 F.2d 228 (2d Cir. 1974); Bolger v. Laventhol Krekstein Horwath & Horwath, 381 F. Supp. 260, 267 (S.D.N.Y. 1974).

C. Under § 10(b) Frigitemp Has Alleged And Is Entitled To Recover Its Actual Damages And Defendants' Profits

Frigitemp has alleged that a class action has been brought by its shareholders to recover market losses and that such losses have resulted from defendants' unlawful manipulation of the price of Frigitemp's shares. Frigitemp seeks recovery of the damages it pays on account of and the expenses it incurs in defending that class action.

Defendants contend that such damages are not recognizable under the 1934 Act, citing Madigan, Inc. v. Goodman, 357 F. Supp. 1331 (N.D. Ill. 1973), rev'd on other grounds, 498 F. 2d 233 (7th Cir. 1974). However, in Madigan, the Seventh Circuit found that the expenses of certain related litigation were not recoverable since they were not a direct consequence of defendants' alleged fraud. Here, exactly the opposite is true. The defendants' acts caused vast fluctuations in the price of Frigitemp's stock occasioning substantial losses to those who bought at artificially inflated prices, and for which losses Frigitemp has been sued in Kaye v. Lee. Defendants should be required to compensate Frigitemp for its damages and expenses which were a direct consequence of defendants' manipulation. Zeller v. Bogue Electronic Manufacturing Corp., 476 F. 2d 795 (2d Cir. 1973); Bailes v. Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971).

Moreover, Frigitemp's claim for disgorgement of defendants' profits is proper under § 10(b). Zeller v. Bogue Electric Manufacturing Corp., supra. Indeed, in Ohio Drill & Tool Co. v. Johnson, CCH Sec. L. Rep [1974 Transfer Binder] ¶ 94,596 (6th Cir. 1974), the court held that disgorgement of defendants' profits was proper even in the absence of plaintiffs' out-of-pocket losses. Haberman v. Murchison, 468 F. 2d 1305 (2d Cir. 1972), relied upon by defendants is not relevant. The corporation on behalf of which that action was brought was neither a purchaser or seller of any securities and therefore the court held it had no standing to sue.

POINT II

THE INDIVIDUAL PLAINTIFFS SHOULD BE PERMITTED TO MAINTAIN THEIR CLAIMS UNDER § 10(b) AND AT COMMON LAW

A. The Individual Plaintiffs May Sue Under § 10(b) of the 1934 Act

The individual plaintiffs contend that the defendants fraudulently induced them into contributing 100,000 shares to the capital of Frigitemp as a condition of the Private Placement by withholding from them the information that (a) the Funds had purchased and would continue to purchase approximately 74% of the publicly held shares of Frigitemp; (b) the defendants would use inside information disclosed to them in the Private Placement in continuing this stock acquisition program and (c) the purpose of the defendants in requiring the contribution to capital of 100,000 shares was to increase the value of the shares purchased and to be purchased in the open market by the Funds.

With respect to non-disclosures of defendants' past market purchases, defendants rely upon Judge Tenney's conclusion that the individual plaintiffs knew or should have known of said purchases. We respectfully submit that Judge Tenney was incorrect in so ruling. Frigitemp, like almost all other public corporations, did not maintain a continuous record of the number of shares held by each of

its shareholders. Rather, it received sheets from its transfer agent indicating daily transfers of its shares. Frigitemp's officers had no reason to aggregate this data on the daily transfer sheets to determine the number of shares the Funds had purchased. In addition, a substantial period usually elapses between the time a purchase of shares is made in the market, is settled and paid for and is delivered for transfer of record. There is no basis in the record to conclude that on August 1969 plaintiffs had in their possession any information which would have disclosed the defendants' stock acquisitions. Frigitemp went public on January 15, 1969 (A87a). The defendants' stock acquisitions began March 20, 1969 (A40a). Negotiations for the Private Placement began in June 1969 (A136a) and the transaction closed on August 29, 1969 (A7a). There was presented to Judge Tenney no proof of what, if anything, Frigitemp's transfer records disclosed, between June and August 1969, as to the defendants' stock holdings. In addition, Frigitemp's president denied knowledge of defendants' stock holdings prior to the Private Placement and there was no showing that any stock transfer records were even available to the individual plaintiffs other than him. Nonetheless, Judge Tenney incorrectly concluded that plaintiffs knew or should have known that the defendants had made substantial purchases of Frigitemp's stock.

Even if the Funds' purchases had been transferred on Frigitemp's stock transfer records, only the accumulated daily transfers would have been delivered to Frigitemp's officers. They are not chargeable with the knowledge only an analysis of this data would have yielded. Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F. 2d 930 (2d Cir. 1975). They had no reason to cumulate the data on the daily transfer sheets to determine the extent of the Funds' purchases.

Defendants urge that they had no duty to disclose their intentions to make purchases after the Private Placement. Thus, defendants position is that having received inside information in the Private Placement they had no duty to disclose their intention to trade on that inside information to corner the market. Their position is directly contrary to existing case law. Thus, in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), the Supreme Court stated the standard to be applied in determining the validity of a claim under Rule 10b-5:

> "Under the circumstances of this case, involving primarily a failure to disclose positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." (Citations omitted) (Emphasis added).

Moreover, in List v. Fashion Park, Inc., 340 F. 2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811, petition for rehearing denied, 382 U.S. 933 (1965), this court stated:

> "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact . . . . To put the matter conversely, insiders 'are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.' . . . This test preserves the common law parallel between 'reliance' and 'materiality,' differing as it does from the definition of 'materiality' under Rule 10b-5 solely by substituting the individual plaintiff for the reasonable man." 340 F.2d at 463 (Citations omitted) (Emphasis added).

Under the foregoing principles of law, the facts withheld from the individual plaintiffs were material in that they were important to them, and would have influenced them, as fiduciaries of Frigitemp, in making their decision.

Defendants were duty bound to disclose their intention as to intended future stock purchases based upon inside information. Accordingly, defendants' non-disclosures are actionable under § 10(b).

B. The Individual Plaintiffs May Sue for Fraud Under New York Law

Defendants argue that they had no duty to disclose to the individual plaintiffs that they intended to use inside information revealed to them in the Private Placement to purchase additional shares of Frigitemp in the open market. They concede that under New York law such a duty arises if there exists a relationship of trust or confidence. Wood v. Amory, 105 N.Y. 278, 282 (1887). Judge Tenney recognized that the defendants "entered into a 'special relationship' with Frigitemp upon receiving nonpublic information in connection with the Debenture Purchase. Consequently, defendants may be held liable to Frigitemp for profits made even though they are not fiduciaries in the conventional legal sense." (A191a). To the same effect is Shapiro v. Merrill Lynch Pierce Fenner & Smith, Inc., 353 F. Supp. 264, 273 (S.D.N.Y. 1972) aff'd 495 F.2d 228 (2d Cir. 1974). Thus, there here exists the requisite relation of trust and confidence upon which a common law claim can be based.

POINT III

THE COMPLAINT IS LEGALLY SUFFICIENT UNDER RULE 9(b)

The defendants contend that the complaint does not allege fraud with the particularity required by Federal Rule 9(b). They rely upon Segal v. Gordon, 467 F.2d 602 (2d Cir. 1972) where the complaint alleged, in conclusory terms, the commission of fraudulent acts but did not spell out what those acts were claimed to be.

In the case at bar, the complaint spells out in detail the facts, as known to plaintiffs, of the Funds' wrongful acquisition of all but a small part of Frigitemp's public float as a part of defendants' manipulation of the price of the stock; of extensive trading on the basis of inside information furnished to the defendants in confidence; and of failing to disclose the foregoing to the plaintiffs.

So long as a complaint contains facts and particulars which tend to establish fraud, it satisfies the requirement of Rule 9(b). Hirschfield v. Briskin, 447 F.2d 694 (7th Cir. 1971).

The particularity required of a complaint for fraud has been defined as follows:

> "Rule 9(b), as it has been construed by the courts, does not require that fraud be pleaded with absolute and detailed particularity. All that is required is that the circumstances constituting the alleged fraud be pleaded with sufficient definiteness so as to advise the adversary of the claim which he must meet." United States v. Gill, 156 F.Supp. 955, 957 (W.D.Pa. 1957).

In the case at bar the defendants are certainly fully and amply advised of the claims which they must meet.

As the Second Circuit observed in Segal v. Gordon, supra. at p. 607-8:

> "A complaint alleging fraud should be filed only after a wrong is reasonably believed to have occurred; it should serve to seek redress for a wrong, not to find one."

The wrongs committed by the defendants have been specifically alleged and redress for those wrongs should be permitted.

CONCLUSION

The District Court's order dismissing all of plaintiffs' claims should be reversed in its entirety.

Dated: New York, New York
April 30, 1975

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Service of ~~three (3)~~ Two (2) copies of the within
reply brief is hereby admitted
this 1st day of MAY, 1975 3:25PM

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Service of ~~three (3)~~ Two (2) copies of the within
reply brief is hereby admitted
this 1st day of May, 1975

BUTOWSKY, SCHWENKE & DEVINE
RECEIVED
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